An Adjusters Guide to Increase in Cost of Working - Payments Made Beyond the Maximum Indemnity Period

By the CILA Business Interruption Special Interest Group

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Background

This paper was originally issued by the CILA Business Interruption Special Interest Group as "Payments made beyond Maximum Indemnity Period ('MIP')". However, the position on Increase in Cost of Working ('ICW') has moved on and a detailed review at this point may be useful for working adjusters.

In passing we would refer to the following publications:

- The Basic Business Interruption Book published by the CILA in April 2020, which includes examples of possible ICW for consideration within the policy framework: https://www.cila.co.uk/the-basic-business-interruption-book

- Business Interruption Policy Wordings: Challenges Highlighted by Claims Experience, published originally in 2012 by the Insurance Institute of London (revised in May 2019), which discusses various aspects of ICW: https://www.cila.co.uk/cila/downloads/sig-downloads/business-interruptions/files-9/13-bi-policy-wordings/file

Policy Cover – Increase in Cost of Working

There is no such thing as a typical policy definition anymore. However, common features for ICW within UK Business Interruption policies are as follows:

- Additional expenditure (i.e. an actual increased cash cost)
- necessarily and reasonably incurred
- for the sole purpose of avoiding or diminishing the reduction in turnover which but for that expenditure would have taken place during the Indemnity Period as a result of the Incident
- but not exceeding the sum produced by applying the rate of gross profit to the amount of reduction thereby avoided.

The last point is often referred to as “the economic limit” whereby Insurers will pay an amount for Increased Costs of Working up to, but not more than, the amount that they would have paid had the money not been spent and the loss on the reduction in turnover had arisen.

Examples of Increase in Cost of Working

ICW will generally arise from deliberate action by the Insured. It is no surprise that following an insured incident a policyholder will wish to protect sales, which will be at risk following the damage. Such actions will usually incur additional costs.

While the policy includes cover for lost turnover (at the appropriate Rate of Gross Profit) a lost sale results in a dissatisfied customer and potential for continuing losses. This is particularly relevant in a competitive market where the customer can find alternative suppliers and loyalty may not be enough to secure future trade after an interruption to normal services. Recovering, or even replacing, a lost customer is much more challenging than maintaining an existing customer. So, the ICW cover allows policyholders to mitigate and manage the loss (for the benefit of all).

Common examples of ICW include:

- Sub-contracting – where normal production is no longer possible due to Damage to equipment or premises, that may be sent to a third-party contractor. The ICW claim will reflect the invoiced costs from the sub-contractor and haulier, but should be net of any costs (materials, consumables etc), which the Insured would have incurred had they manufactured the products themselves;
- Courier costs, or airfreight, to deliver delayed production to customers within their specified delivery timetable;
- Additional overtime for the Insured's production staff once the plant and equipment is repaired or reinstated such that deferred or delayed customer orders can be satisfied (albeit the ICW should reflect the costs of additional overtime over and above any normal level of overtime that may have been incurred had the Damage not occurred);
- Temporary repairs to the premises or equipment allowing manufacturing to continue until a suitable permanent repair can be arranged;
- Premium cost of accelerating the re-instatement to reduce the indemnity period.

Sometimes, the benefit of ICW can be directly linked to specific customers. Often, however, it may not be possible to evidence a direct link with specific sales: renting a temporary warehouse for stock storage or an office building for administrative staff, for example. To the extent that these costs allow continuing sales that would otherwise be lost (and are economic by reference to those sales) they still fall for consideration as ICW.

Or the business may establish a temporary alternative workplace fully equipped to continue their own operational processes and to maintain deliveries to customers.

In all cases it is important that the turnover reduction avoided by such expenditure arises within the MIP.

Who bears the risk?

There will be times when the decision to commit to ICW may seem attractive and likely to be successful – but this is not always the case. Customer needs may drive them to competitors and even a short interruption may threaten a significant loss of Gross Profit.

Stock undamaged in an incident might allow immediate customer needs to be satisfied, or unique specifications and licensing may bind customers to the Insured, and a short interruption may be tolerated as unavoidable.

However, these issues are difficult to predict, and customer reactions may vary. Uncertainty over the sales benefit of ICW at the point that the expenditure needs to be incurred can make it difficult to definitively assess the economic limit at the time that the expenditure decision needs to be made.

The Insured may be reluctant or unable to commit large amounts of their limited capital resources after a loss has occurred towards a project that may not ultimately be covered (in full) by the insurance policy.

In this case it is best practice for the adjuster to request a succinct business case to be prepared by the Insured– proposed expenditure and anticipated benefit that would achieve, with an assessment of associated risk factors – and this can be reviewed and discussed with Insurers, and an appropriate response can then be given.

Particularly for expenditure plans which include a high initial commitment – perhaps rent and fit out for temporary premises for production – an Insurer may decide to provide a commitment to cover these costs irrespective of their ultimate specific economic measure. This would allow for early recognition of these costs in interim payments as well as certainty in the planned actions, and gives the Insured some confidence in undertaking the agreed mitigation actions for the benefit of all.

Given that in many cases, the economic limit is difficult to measure in isolation, agreement to fund the mutually agreed strategy is a pragmatic approach often adopted. So, as an example, if a temporary piece of equipment is going to be bought that the Insured may want to keep permanently, agreeing a residual value before it is purchased will avoid surprises.

Of course, where an Insured does not communicate with regards plans, or significantly overspends agreed amounts, the retrospective application of the economic limit would be appropriate.

It is worth noting that ICW cover is provided as a separate item to savings (costs that have not been deducted from turnover to calculate Gross Profit, but which nevertheless reduce due to Damage). There can be anomalies where the cost of renting an alternative building is not economic, but which becomes so when the rent saving at a damaged building is taken into account. Whilst technically the economic limit is measured with reference to ICW in isolation, if that would produce the wrong answer adjusters should be mindful of the overall impact on the claim.

Costs outside the Maximum Indemnity Period

There are situations where a reduction in turnover within the MIP is achieved at the expense of ICW costs arising after that period has expired.

Examples of such ICW commonly include:

- Rental payments for temporary premises after the MIP has expired (where a short lease coinciding with the MIP could not be secured);
- Moving costs to return to the original premises after the MIP has expired
- Costs of dilapidations of leaving temporary premises

It is important to consider the benefits being recognised by both parties here arising from the ICW– the Insured and the Insurer.

If the Insured has moved back into the reinstated permanent premises before the end of the MIP, then all of the costs will fall for consideration as ICW in the claim. That is because all of the reduction in turnover has arisen within the MIP. If the permanent re-instatement does not take place for say a year after the MIP has ended, part of the ICW will have avoided a reduction in turnover within the MIP (for the benefit of the Insurer), and part has avoided a reduction after it has expired (for the benefit of the Insured). Where both have benefitted, both should contribute to the cost.

The timing of the reduction in turnover is the driver for cover, not the timing of the ICW expenditure (with the exception of ICW only policies). This principle was confirmed in the case of Synergy Health (UK) v CGU and others (2010).

To expand on the above: assuming a 12-month MIP, if the Insured needed temporary alternative premises for only say 9 months (all within the MIP) but the lease negotiations could only be agreed for a minimum rental period of 24 months, there are surplus rent costs for 15 months and the Insured has no benefit here (assuming no sub-letting is possible). In this case the total costs of the entire two-year period can be considered as necessary (and solely) to support the sales generated in the 12-month MIP that may otherwise have been lost. The economic test will still apply (in the absence of a pre agreed business plan).

If however the 12-month MIP period is too short and the repairs at the damaged premises continue beyond the MIP date, then the Insured has also received some benefit as the rent is supporting sales that would otherwise be uninsured and lost for the business without the expenditure on temporary premises etc.

It is not for us to be prescriptive in this paper, but ultimately a method needs to be agreed to share the costs between the Insurer through the policy cover and the Insured for the uninsured aspects. There are various methods that may be applied including, but not limited to:

- to allocate the aggregate costs on a time basis relating to the periods over which the benefits (i.e. sales secured that would otherwise have been lost) have been recognised; or
- to reflect the relative value of sales protected – part within the MIP and those continuing outside the MIP; or
- the Insured could purchase the temporary facilities that have been originally paid for by Insurers and used within the MIP, for use outside of the MIP.

Generally, it is preferable to agree the approach at the outset or when it first becomes apparent that costs will arise outside the MIP and there is some benefit to the Insured.

Underinsurance

Most business interruption policies ae now written on a declaration linked basis, and usually not subject to proportionate reduction (average) if declarations are reasonably made. There are some policies that are subject to proportionate deduction: any payments made through the policy for either loss of Gross Profit on a reduction in turnover, or ICW would likely reflect a proportionate reduction for the self-insured element.

Accordingly, when considering substantial increased costs of working as part of a mitigation plan, early consideration should be given to the adequacy of the BI declaration or sum insured, and the impact of any inadequacy in those should be explained to the policyholder – who may otherwise be unaware.